RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P. O. Box 1759, La Jolla, California 92038
Minimum of 26 Letters per year — $185 Annually
Registered with the Securities and Exchange Commission

September 10, 1981 **LETTER 817**

Aug. 28, DJIA 892.22; PTI 1458; A-D Ratio –21.71
Sept. 4, DJIA 861.58; PTI 1438; A-D Ratio –22.78

THE PICTURE: In the July 15 mailing I stated that under Dow Theory a primary bear market was in progress (the bear signal was given on July 2). Wall Street, Main Street and almost every other street ignored the warning, and those few who did notice snickered that the Dow Theory was just a technical antique, a dusty relic of the past.

In subsequent Letters I wrote that this complacency was in itself ominous, and I warned that the bear (then in hiding) would ultimately come out in full view. On August 21 my Primary Trend Index (PTI) broke its rising trendline, and since then its been down, down, down for the market. To put it another way, the bear has finally captured Wall Street's attention.

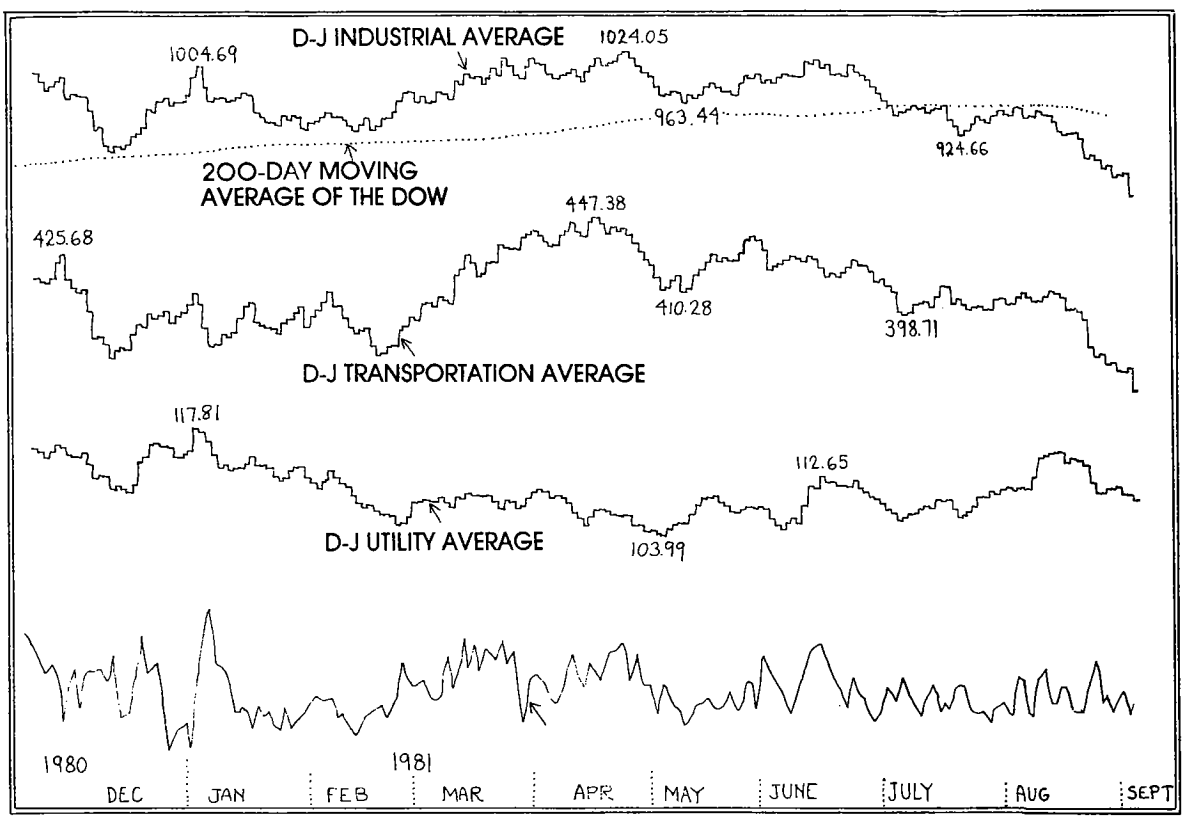
This may be a good time to go over the three phases of a primary bear market. The *first phase* of a bear market is the one that sees stocks sell minus the froth and frenzy of the preceding bull market peak (we are seeing that now). The *second phase* is the one in which stocks go down as they reflect the obviously deteriorating state of business (unemployment, tumbling profits, bankruptcies). The *third* or *final phase* of a bear market is the distress phase. It is here that the good stocks (the blue chips) are thrown over for no other reason than that their owners need to raise money. It is my opinion that we are now near the end of the first phase of this bear market with the second phase waiting somewhere ahead.

FRONT PAGE COMMENT: On August 27 before a group of Republicans, President Reagan attacked the Fed for its high interest rate policy. A week later somebody must have told the President what was happening. It wasn't the Fed that was running interest rates through the roof, it was the spector of an $80 to $100 billion US deficit in 1982. In the face of this revelation, Mr. Reagan announced that he would cut up to $75 billion from the 1983 and 1984 budgets, and that he would slice more from the 1982 budget which he had signed only a few weeks earlier.

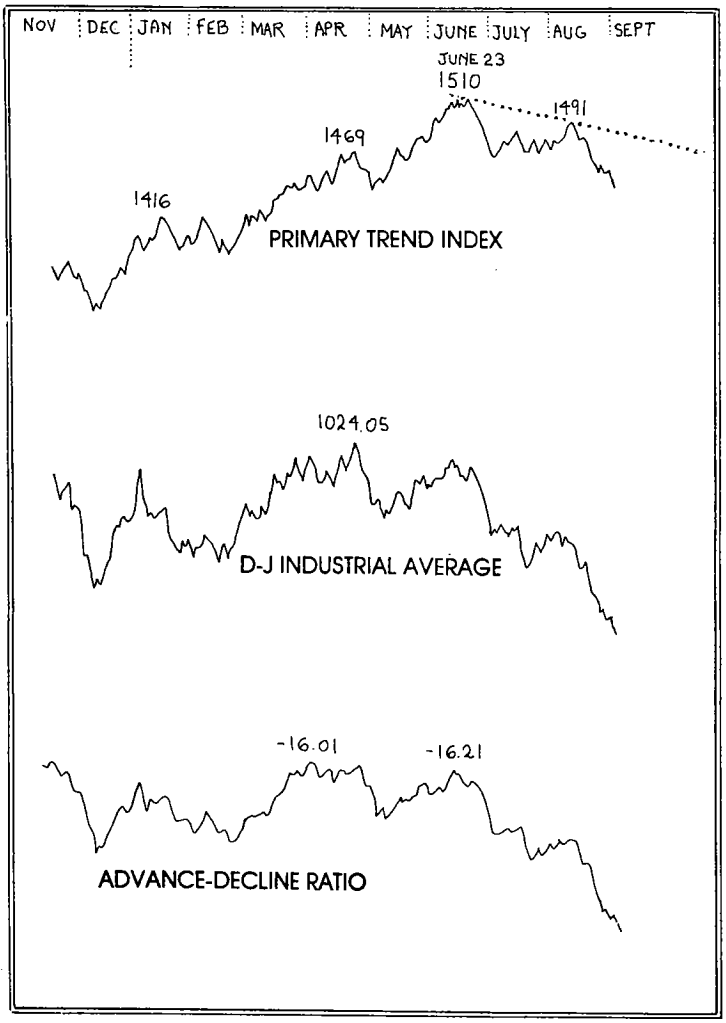
The grim fact is that the Treasury is now bidding for new billions of dollars almost weekly while refinancing old paper (often in the 5% to 10% rate area) at today's near-record rates of 15% to 16%. The result of this adding and compounding action is to run US expenses into the wild blue yonder. Thus, what I have been warning about for over two years is now coming to pass. The average maturity of US Treasury debt is down to approximately 3.9 years, and this debt is now rolling over and compounding at the highest rates in history. Result: the US Treasury is literally eating itself up alive.

What is the solution? The only solution is a balanced budget (a surplus would be preferable) and a policy of nothing but balanced budgets. But wouldn't that bring on depression? The answer is perhaps, but the US could survive depression and deflation (we've done it many times before). But no nation can survive hyperinflation. So the choices must be made.

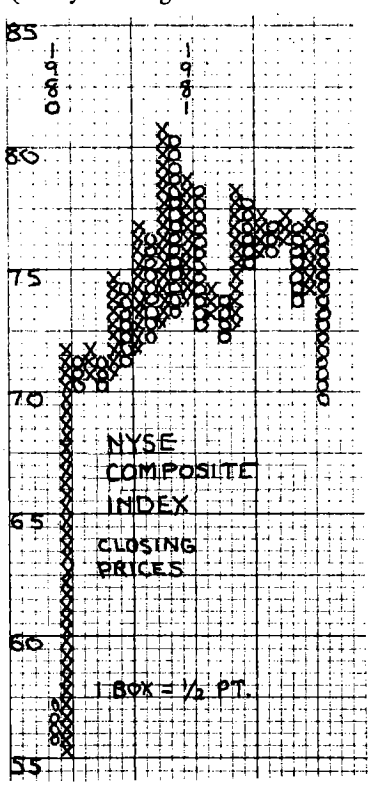
HOW BIG IS THE BEAR? In previous Letters I offered the opinion that the top being formed in the major stock averages was of *major* proportions. In fact, in examining the point & figure chart of the NYSE Composite Average (page 2) it is clear that distribution of stocks began last August. That means that a year-long top has now been shattered.



The decline has been shocking in its intensity. On the week ending August 28, for instance, the stock market lost over $50 billion in values, the D-J 20 Bond Average sank to historic all-time lows, while commodities fell in unison. I figure that in the single week ending August 28 a minimum of



$150 billion in assorted security and commodity values were lost (to say nothing of the values that were lost in mortgages).



With the bear emerging into full view and security prices across the board being decimated, it will be only a matter of time before business itself feels the full grip of the bear. The slump in housing and autos has been making the headlines, but my guess is that before the year is out a few major bankruptcies will also grace the financial pages (*International Harvestor* and *Pan American World Airlines* are two prime candidates).

People are calling to ask, "How bad do you think it will be?" I answer that I don't know, but my guess is that this country is going to have a very rough time into the forseeable future. After all, I reason, for forty years the US has been spending money it hasn't earned. So now we will probably go into a period where we will lose many of the goodies that we never paid for or deserved. In other words, a bear market is pay-it-back time, and the guy who can't pay it back ends up looking for another job or simply going down with the ship.

The great tragedy of this bear market is that it is happening to a President who means well but arrived 20 years too late. When the Washington Republicans said in triumph (a few months ago) that the easy part of their program was the budget cuts and the hard part was the tax cuts, I knew they were wrong. Why? Because they never really made the necessary budget cuts. Now, as the tidal wave of illiquidity, high interest rates, huge deficits and new expenses hits the budget, we see the harried Administration going back to cut the military by $30 billion (this in the face of the hoped for military build-up). Thus, the "supply-side" plans and predictions are running into the brick wall of reality.

I've said for years that when it comes to economics, politicians don't move the economy, the economy moves the politicians. A creaking economy now threatens to cast a new look over Washington and over the nation. The new look is called "cut and save." From here on, Washington will be wrestling not with the Russian bear but with the Wall Street bear!

MARKET: As I wrote in the last Letter, a bear market seeks to go down while taking the greatest number of (optimistic) stockholders with it. The bear loves company. As this bear market progresses, money will be lost, countless millions will be lost by those who are probing, predicting, groping (almost daily) for "the bottom." To my subscribers I say, "Forget the bottom for the time being. We have a ways to go, and the road will be hard and rocky." I would like my subscribers to stay with their 91-day T-bills, to exercise patience, and to ignore most of their bullish neighbors. When the right time comes, I will recommend buying stock again. Until then, conservation of capital is the number one priority, and by holding T-bills we are doing just that.

As you can see on the page 1 chart, the Averages have been sinking in almost perfect bear market fashion with only the Utilities dissenting. But the Utility Average plays no part in Dow Theory, and I expect the Utilities (in due time) to drop through their 1981 low of 103.99. Over the past week both Industrials and Transports have tumbled to new 1981 lows, and the bear seems to have taken firm command.

Turning to my chart of the Primary Trend Index, the PTI has now definitely broken down. A bear trend has been established below what is now a two-month old descending trendline. It is remarkable that the real downside momentum in the stock market did not get underway until the PTI (on August 21) broke below its main rising trendline.

The A-D ratio has now dropped to its level of May, 1980, at which time the Dow was in the low 800 area. Thus, the general market (as measured by the A-D ratio) is weaker than the blue chip segments (as represented by the Dow). This is probably due to the fact that the large Dow stocks are better able to cope with high interest rates than are the average companies represented by the A-D ratio.

The point & figure chart of the NYSE Composite Index (page 2) shows that the latest market decline has shattered the entire top structure that has been building in the Composite since November, 1980. If the 70 level is violated on the Composite, there isn't any real support on this Index until the 55-60 area.

Yes, there will be rallies, there will be pops, there will be explosive advances. And each will be greeted as "a new bull market."

But again I say, "Sit tight, don't be fooled, let the bear have his fun." When the real turn comes, I think I'll be able to identify it. So don't be "hooked" by those whose hopes and wishes rule their brains.

INVESTMENT POSITION: During a bear market, our greatest enemy is *fear.* No one, absolutely no one escapes unscathed from a primary bear market. Some lose their jobs, others lose their money, while still others lose their confidence as their "best made plans" go down the drain.

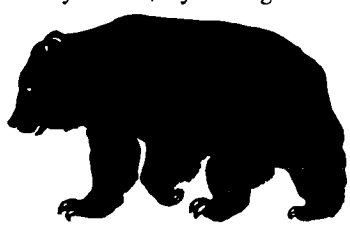
One of the most effective ways of countering fear is with knowledge. It is for that reason that I have delved so deeply into the US monetary, debt and deficit problems. I want people to understand what is happening, because understanding helps you to ACT.

In view of the primary bear market, I have advocated putting our money into 91-day Treasury bills. The bills will be one of the few islands of safety during the course of this primary bear market. Furthermore, ownership of T-bills will serve to allay fears – and in the process the bills will also pay us handsomely.

Nothing means anything to the man or woman who has lost peace of mind. No profit, no triumph, no endeavor is worth the price if you find yourself laying awake nights. If you have followed my instruction and moved into T-bills (with token positions in gold) you will be at peace. You will have the equanimity and balance to take the next step when the time comes.

I have been asked about shorts and puts. In 25 years of dealing with investors and subscribers, my general advice is to forget them. Remember, cash in a bear market really amounts to a short position since your cash is worth more and more as the market declines. But in shorts and puts, you are speculating for the decline (while paying out dividends), and you are playing against time. The fact is that most people tend to lose money in puts and shorts. So my advice is to compound your money at high interest rates rather than trying to increase your money through shorts and puts during a bear market.

The bear is growing, and for that reason I've featured a larger bruin in this box. Treat him with respect!



MONEY, MONEY: Question: Russell, you've been predicting an interest rate spike and a collapse in the bond and money markets. So far, you seem to be right on target. You've also said that one of the great plays will be buying bonds at record yields, then collecting these high yields plus capital gains as the bond market finally turns up. Would you elaborate please.

Answer: The great American financial tragedy is accelerating. The current short-term debt of government, business and consumers is approximately $1.2 trillion. Between 1978 to 1980 short-term US Treasury obligations rose from $100 to $160 billion and they are still careening upwards. By the end of 1981 they will be above $220 billion. The Treasury has stated that it will raise up to $33 billion in new money in the fourth quarter, double its financing needs in the third quarter. And for first quarter 1982 the Treasury will have to raise another $30 billion in new money. The financing needs of the US, like its spending, are out of control! My studies have convinced me that the US is moving into a vicious credit crisis. The crisis will be climaxed by an interest rate spike, set off by a broad panic in the money and bond markets. How long and how high the spike will go I cannot tell now. At some point, the panic will be on full force, the economy and major corporations (and individuals) will be forced to the wall, and in due time the interest rate spike will hit a spear point peak. Hopefully, I will be able to identify the spear point peak and it is there that we will buy long-term Government bonds.

Question: Great, Russell, and what makes you think you can identify the peak?

Answer: Obviously, I can't guarantee that I'll hit the exact peak of interest rates, but I think I'll come close. And "close" should be good enough.

Question: What will finally turn this bond and money market bullish?

Answer: I've said many times that the markets have a way of FORCING REALITY on politicians. Well, the money markets are going to force reality on today's politicians. As interest rates spike upward, politicians will have to finally come to grips with this out-of-control Government budget situation. They will HAVE TO make huge cuts, they will HAVE TO balance the budget, they will be FORCED TO do whatever is necessary to convince the money markets that the orgy of deficit spending is over.

The public and the professionals have become very sophisticated about money, deficits, over-spending, political lies and Presidential good intentions. The money markets aren't fooled any longer by the kind of nonsense and malarkey that used to come out of Washington. We're moving nearer and nearer the point where this nation must either cut expenses to the bone and take a depression – or move into hyperinflation and take a wipe-out in buying power plus a destruction of our capital markets. I'm betting that we'll take the depression.

Question: But how can the over-spending and deficit problems ever be resolved?

Answer: I believe that the US Government could be literally CUT IN HALF and the nation would continue to function successfully. The waste, the stupidity, the deceit, the feather-bedding, the over-lapping in agencies is all BEYOND BELIEF. Before it's over, the Government will have to be decimated, cut down to a workable and sensible size. The military and policing functions will have to be kept, but even here the over-lapping and waste is fantastic. All this will have to be brought into some kind of sane proportion.

Then, there are the inefficient businesses, the waste in industry, the industries that can't compete any longer. They'll be hit with massive bankruptcies. Once all this water is squeezed out of the economy, once the great inflation-sponge has been squeezed, there will be a gradual running off of bad debts, and this purging will put the economy back on the track again.

Remember, since World War II a huge inflation-bloated economic edifice has been built. There has been no real correction of this edifice in 40 years. When the balloon is finally pricked, the corrective process will begin. Before it is over, the excesses will turn to leaness, the loans will be cancelled, rescheduled or paid up, the credit system will be shrunk to normal proportions, and the money markets will have gained confidence again. Then a major new bull market in bonds will materialize.

Remember, since World War II this nation has constructed a huge, inflation-bloated economic edifice. A generation has grown up which has never seen hard times, never seen a lowering of wages, never seen deflation, never seen vicious international competition, never seen men and women looking for jobs instead of wage boosts. Never before in American history have we gone through a 40 year span without a major economic correction. But the longer the correction is put off the more devastating the ultimate bear market correction.

After the night comes the dawn. And it is well to remember that once the excesses are purged from the economy, the tide is set to turn. And that is where the bond market will reverse to the upside. As a rule, the bond market must hit bottom BEFORE the stock market hits bottom. For that reason, I do not expect a new bull market to begin in stocks until this bond market hits its low, stabilizes and then turns bullish.

Question: Russell, what makes you think that T-bills will hold up in the scenario you have painted?

Answer: I have faith in the ability of the American people to ultimately return to sanity. Once Americans see what the New Deal, The Fair Deal, the Great Society, and the big deal have done to this country, they will opt for the honest deal, and that does not include spending your head off and paying the debtor with printing press money.

The American people also know that they must pay their obligations, and the number one Federal obligation, the shortest-term obligation of the nation is the Treasury bill. These bills are backed by the full faith and credit of the US. They must be honored or the nation declares bankruptcy. I do not think this will happen – regardless of the sacrifices necessary to keep us solvent.

Question: Is it OK to leave my T-bill account with a broker or with a bank?

Answer: Yes, but make sure that you are using a reliable broker and a solvent bank. You might ask for a letter from your bank or broker stating that your T-bills are held in an account which is SEPARATE from the assets of the broker or bank. As far as I know, this is the way most brokers and banks are set up. For instance, a large broker will buy a huge batch of T-bills for many clients at each weekly auction, and this whole allotment of bills is held in an account separate from the broker. But you should check with your broker and find out if this is the procedure that is followed.

Another perfectly legitimate (and easier) way of holding your money is in one of the recommended money market funds listed in the last Letter (these are all funds which hold only short-term Government obligations).

NOTES & QUOTES: James Chace, managing editor of Foreign Affairs, has written a book entitled, *"Solvency, the Price of Survival"* (Random House, $9.95) and believe it or not, Chace presents the real story of what's happened to America. Chace's major point is that until we put our economy in order, we can rearm to the teeth and still be weak. Or, as Chace puts it, "For if we remain insolvent, how can we have a foreign policy at all?" Chace states that neither the leader nor the people are willing to ask or face the sacrifices in standard of living that must be faced but instead we have opted to live off imports while paying for these with printed dollars. He notes that in 15 years "our debts have tripled while the productive capacity to repay them has only doubled." In other words, we've borrowed $2 for every $1 of productive capacity we have created. In all, a most important book.

* *

In an August 21 piece Dr. Henry Kaufman (*Salomon Bros.*) shows the changing impact in corporate interest payments. It's an eye-opener. For instance, in the 1961-65 period total corporate funds allocated to interest payment was 8.6%. In the 1966-70 period the percentage jumped to 14.4%. For 1980 (are you ready for this) total corporate funds allocated for interest payments rose to 31.2%. In other words, almost 1/3 of all corporate funds last year went to paying interest. Question: what happens if profits plummet?

* *

Jamaica's economy is on the verge of collapse, yet foreign currency keeps pouring into the island. Reason: Jamaica exports about 7% of all the marijuana used in the US. This brings in an estimated $1 billion to Jamaica yearly.

* *

Subscribers from all over the nation send me news clips, and this helps me to get a "feel" for what is happening (the local news clips are often fascinating). From the *Seattle Times* (Aug. 24) comes the shocker that the State of Washington will ask its largest banks to accept "state interest-bearing registered warrants" for loans. Problem, Washington is "financially distressed" and hasn't got first-of-the-month cash to pay its employees.

From Oregon comes news that during May through July 225 home-building companies declared bankruptcy. Said the head of the Portland Home Builders Association, "The market has been bad, but at least we've been building. Now it's completely collapisng."

* *

And while building is collapsing in the Northwest, *Town and Country* magazine (Sept. issue) features an article on the "panic" in NYC real estate. In the City, there has been a huge influx of wealthy foreigners. Prices for choice apartments and buildings are going through the roof, with the value of many units having increased 700% to 1000% in the past 10 years. On Fifth Avenue (the most desirable area) values are in some cases rising 10% a month. Manhattan is now the hottest real estate market in the world, and it's the capital of the world as far as foreign wealth is concerned.

* *

Horse-Gold: I thought this clip was interesting. And I wondered why Bunker Hunt was raising race horses!

It has been an astonishing year for horse-trading. On both sides of the Atlantic a wave of buying has given international bloodstock values one of the biggest boosts ever. In Britain the headlines about Shergar, owned by the Aga Khan, grew even bigger recently when the horse, which won both the English and the Irish Derby, was syndicated for stud in Ireland for $18 million – or $450,000 for each one-fortieth share.

* *

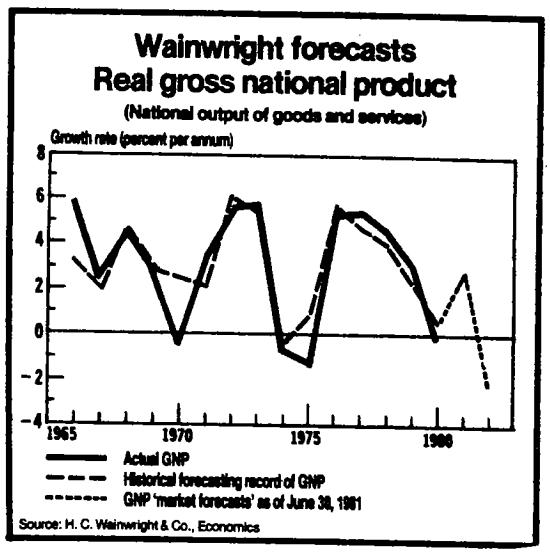
Russia is facing its own brand of troubles. With an economy 60% as large as ours, Russia is spending the equivalent of $25 billion a year on its six Warsaw Pact nations (in Eastern Europe)

and its various satellites from Vietnam to Mongolia to Afghanistan to Cuba. This plus the cost of keeping up the huge Soviet war machine means that there is little left over for civilian production. Soviet citizens have plenty of money but nothing to buy. And they're getting very unhappy about it, very. If I had my way, the West would totally cease making loans to the Soviet allies. Item . . . . . Russia is suffering its third crop-failure year in a row, and Russians are being told to prepare for food rationing this winter.

* *

H.C. Wainwright & Co. an old-line Boston Consulting firm, has constructed an economic forecaster based on T-bill prices. As you can see by this chart, the Wainwright record has been superb. Note that for 1982 the model says "down" for the economy. This (if it's true) will present serious problems for Treasury tax collections. I include further comments from Wainwright's economist, Charles Babin (chart and comments from the Aug. 31 *Christian Science Monitor).* I believe these comments are important.

* *



Instead of sticking with the "supply side" economics he touted in his campaign for the White House, Babin charges, the President signed a program that gives the median taxpayer a net effective tax cut of only 7½ percent for the entire three-year period.

Also, he notes, Mr. Reagan had proposed an immediate indexing of taxes to prevent the "bracket creep" phenomenon which pushes people into higher tax brackets as they receive cost-of-living pay raises. Later, he ditched this proposal as a compromise to help get his package through Congress, only to see Democrats restore it. The problem now is that it doesn't take effect until 1985 – giving Reagan's first term none of the benefit of what Babin feels is this important tax break.

"Until 1985," he asserts, "the present tax cuts are not enough to keep the economy from falling asleep."

What's left, Babin says, is not supply-side economics – nor even the "incentivist" economics his firm believes was the essence of the original Kemp-Roth proposal, with its immediate, across-the-board 30 percent tax cut – but a compromised package leading to bigger federal deficits and heavier government borrowing, which will help keep interest rates high and the economy slow.

And even if Secretary Regan's forecast of a 3.4 percent growth in the GNP were to prove correct, Babin says, it would mean a 15 to 16 percent T-bill rate next year, indicating even higher overall interest rates.

Kids: Robert Rhea, the great Dow Theorist of the 1930's, wrote that "A bear market is a perfect time for a vacation." I haven't taken as much as a 5-day vacation since I started this business in 1958, but I did go up to LA last weekend to see one of my kids. I've talked about Ryan (my 3½ year old) and Lauren (my 8 month old), but people say, "Yeah, all right, Russell, but what did you do in the '50's and '60's?" Well, I was busy then too. One of my previous babies is Betsy Russell, who was sweet 18 on September 6. Bets lives in LA and wants to be an actress (and from what I hear she has a good chance of getting there). Here's a picture of Bets (she's modelling in this one) but wait, I have two other girls from the '50's that I haven't even shown yet!

* *

I've read any number of so-called sex information books, and most of them have been less than satisfactory. A new book by Michael Castleman entitled *"Sexual Solutions"* is a winner (Simon and Schuster $12.95). If you think you know it all, try this down-to-earth volume. (Sex comes right after the stock market as the subject most people are most misinformed about).

* *

T.G.I.F. Thank God it's Football: the football season is upon us, the madness is here. San Diego's Chargers probably have more talent on their team than any other team in the nation. But so far they can't "get it together," or at least they can't make it to the Super Bowl. Maybe this year, maybe . . . . .

* *

I'm embarrassed to reveal this, but I get more letters on my Notes & Quotes column than anything else. Maybe it's just because this is the easy-reading part. But I like to think that it's because I try in this section to include items that will either help people or educate people or at least make them smile. Anyway, I enjoy writing Notes & Quotes so please allow me this little pleasure.

* *

Nobody asked me but my two favorite modern songwriters are Jimmy Webb and Kris Kristofferson (try one of their records, any one of them).

* *

GOLD: Many economists are now thinking wistfully about the good old gold-backed dollar days – and they are opting for a new return to gold. Will this solve our problems? It will not! The US must balance the budget and keep it balanced FIRST before returning to gold. The dollar must be made "as good as gold" first, and then the US can legitimately return to gold. Otherwise, all that will happen is that the US will (if it goes on gold and continues to run big deficits) see a run on its bullion and again have to slam the gold window.

This is the time to be absolutely cold and unemotional about the yellow metal. On my gold-to-common stock ratio, the 3-week moving average of this ratio has now pushed above the 8-week ratio, thereby rendering a definite signal that gold is outperforming the stock market. It is this kind of atmosphere in which gold has made its best advances.

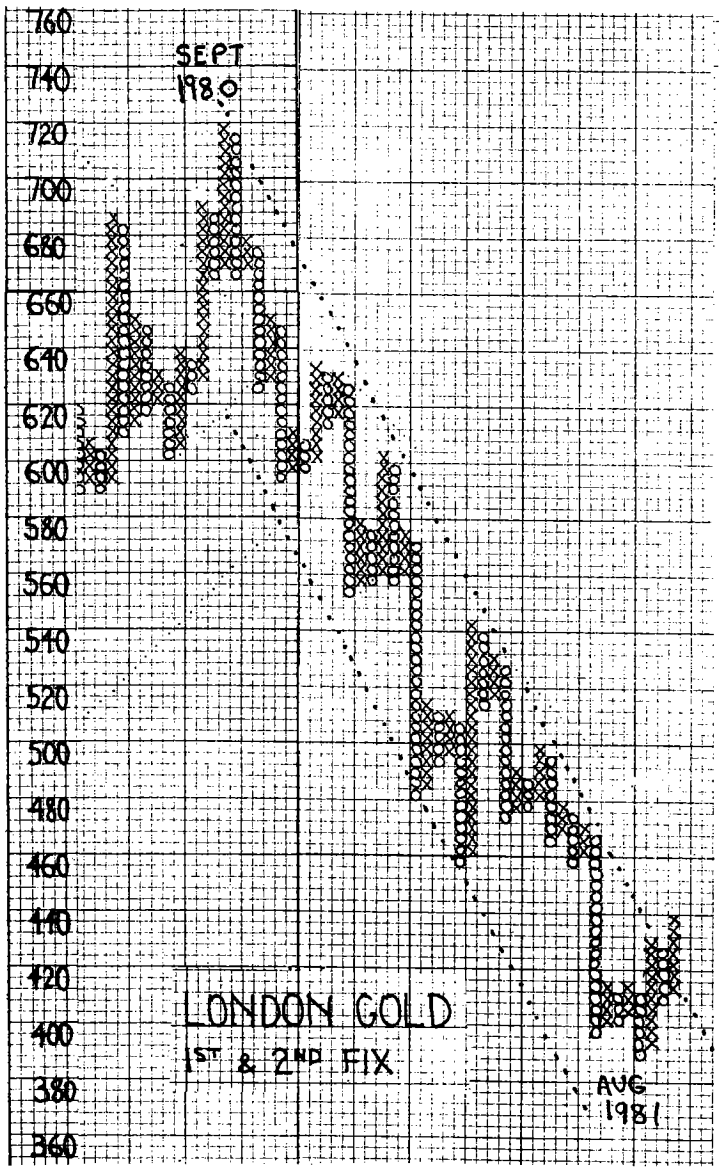
The point & figure chart is a 4 x 12 chart meaning that each box is 4 points and only reverses of 12 points are shown (X's are rallies, O's are declines). As you can see, gold has been in a perfect declining channel for the past 11 months (since September, 1980). The low was hit in August at 392. Following that, a small bottom pattern was traced out, and at 420 a first P & F buy signal was given. On September 4 a second buy signal was given at 436.

Gold has now rallied decisively out of the long down-channel, and the metal should now test the resistance level around 460. Thus our "bottom call" a few Letters ago seems to have validity, and the token positions in gold suggested in that Letter might now be increased.

The moving averages have not turned bullish for gold yet. The 5-week MA is now 421, just 6 points below the 13-week MA, which stands at 427. The 50-week MA is at 488 and dropping at the rate of about 3 points a week. If spot gold can stay above 430-435 the 5-week MA will push above the 13-week MA, thereby rendering a first bullish signal (the big bull signal will come when the 13-week MA rises above the 50-week MA.

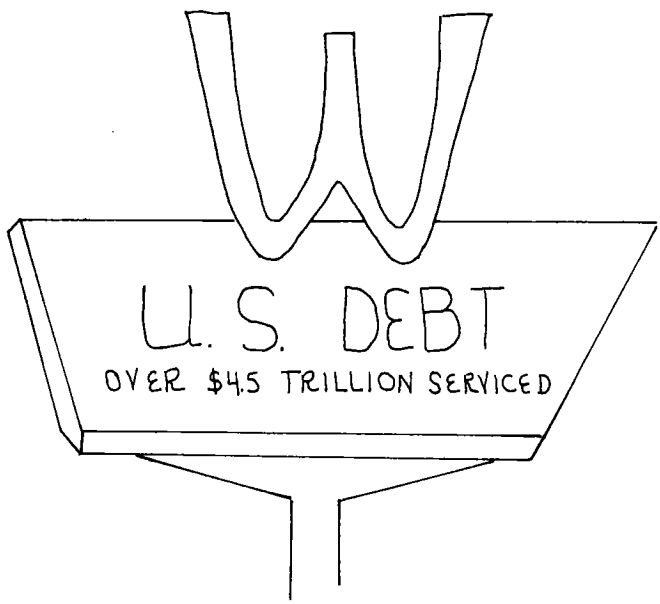
The 13-week rate of change for golds (momentum) is now 91.7, but the big bullish breakout will come when momentum pushes above the June high of 100.

Conclusion: modest gold positions are warranted, but gold must hold above 408 now – if it is to stay bullish.



LATE NOTES: As of September 5 the Dow had dropped five weeks in a row, a rather ghastly performance. The PTI has dropped over 70 points from its 1510 high, but as you can see on the PTI chart (page 2), this market could go a long way on the downside if the PTI is going into a major bear market decline. I'll be most interested to see what the PTI looks like on our first rally (normally, bear market rallies don't tack many points on the PTI).

One of my subscribers, having just left a McDonald's restaurant, saw their sign, and got an idea. Why not reverse the big M and work out a slogan for our big Government. So he drew this logo for Washington (that's what the W stands for). I don't know whether to laugh or cry.



NEXT MAILING: Sept. 23